

**Kentucky Higher Education  
Student Loan Corporation**

**Report on Audit of Financial Statements  
for the year ended June 30, 2003**

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## Report of Independent Auditors

Board of Directors  
Kentucky Higher Education Student Loan Corporation  
Louisville, Kentucky

In our opinion, the financial statements of each major fund of the Kentucky Higher Education Student Loan Corporation (the Corporation), a blended component unit of Kentucky Higher Education Assistance Authority, (a component unit of the Commonwealth of Kentucky), which collectively comprise the Corporation's basic financial statements as listed in the table of contents, present fairly, in all material respects, the respective financial position of each major fund of the Corporation at June 30, 2003 and the respective changes in financial position and cash flows thereof for the year then ended, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express opinions on these financial statements based on our audit. We conducted our audit of these financial statements in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

Management's Discussion and Analysis as set forth on pages 2 to 7 is not a required part of the basic financial statement but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued a report dated September 23, 2003 on our consideration of the Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audit.

*PricewaterhouseCoopers LLP*

September 23, 2003

**Kentucky Higher Education Student Loan Corporation**  
**Management's Discussion and Analysis**  
**(Unaudited)**

The Kentucky Higher Education Student Loan Corporation (Corporation) is an independent *de jure* municipal corporation established by the Kentucky General Assembly in 1978 to provide a loan finance program for post-secondary students in the Commonwealth of Kentucky. The Corporation functions as a lender of student loans, making loans to parents and students directly; a servicer of student loans; and a secondary market for the purchase of student loans from other lenders. The Corporation funds the origination or acquisition of student loans by periodically issuing revenue bonds and notes under various debt agreements, including two general bond resolutions. The Corporation also services education loans and collects defaulted education loans. The Corporation's services and loans are marketed under the registered service mark "The Student Loan People<sup>SM</sup>".

This section of the Corporation's annual financial report presents a discussion and analysis of the Corporation's financial performance for the fiscal year ended June 30, 2003. Please read it in conjunction with the Corporation's financial statements and the notes to the financial statements, which follow this section.

**FINANCIAL HIGHLIGHTS AS OF JUNE 30, 2003:**

- The Corporation's total assets at year end were approximately \$1.1 billion, which is an increase of approximately \$236 million or 26% over the prior year.
- The Corporation's net student loans at year end were approximately \$807 million, which is an increase of approximately \$91 million or 13% over the prior year.
- The Corporation's total revenue for the fiscal year ended June 30, 2003 was approximately \$49 million, which is a decrease of approximately \$8 million or 13% from the prior fiscal year end.
- The Corporation's fee income for the fiscal year ended June 30, 2003 was approximately \$7 million, which is an increase of approximately \$3 million or 87% from the prior fiscal year end.
- The Corporation's interest expense for the fiscal year ended June 30, 2003 was approximately \$17 million, which is a decrease of approximately \$5 million or 23% from the prior fiscal year end.
- The Corporation's total other operating expenses (excluding the provision for arbitrage liabilities and principal forgiveness) for the fiscal year were approximately \$24 million which is an increase of approximately \$8 million or 50% from the prior fiscal year end.
- During the fiscal year 2003, in connection with an incentive program to encourage higher education and certain high-need occupations in Kentucky, the Corporation forgave \$7.9 million in student loan principal and accrued interest. This program reduced the excess yield on certain of the Corporation's outstanding bond obligations by \$7.9 million and had a corresponding reduction in the provision for arbitrage liabilities.
- The Corporation's change in net assets after operating transfers for the fiscal year ended June 30, 2003 was approximately \$5 million, which is a decrease of approximately \$5 million or 48% from the prior fiscal year.

**Kentucky Higher Education Student Loan Corporation**  
**Management's Discussion and Analysis**  
**(Unaudited)**

**OVERVIEW OF THE FINANCIAL STATEMENTS:**

The Corporation's financial statements are prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) as applied on an accrual basis. Under the accrual basis of GAAP, revenues are recognized in the period in which they are earned and expenses are recognized in the period in which they are incurred. These basic financial statements are separated into funds. Certain provisions of each general bond resolution and the line of credit agreement (the three Education Finance Funds) require segregation of assets and restrictions on the use of certain funds. These requirements, as well as certain governmental accounting pronouncements, require this financial statement presentation.

The three basic financial statements presented within the financial statements are:

**Balance Sheet**

The balance sheet presents information regarding the Corporation's assets, liabilities and net assets. Net assets represent total assets less total liabilities. The balance sheet classifies assets and liabilities as current or noncurrent and classifies net assets as restricted and unrestricted according to restrictions in each general bond resolution.

**Statement of Revenues, Expenses and Change in Net Assets**

The statement of revenues, expenses and changes in net assets presents the Corporation's interest income and other revenues, cost of funds, operating expenses and changes in net assets for the fiscal year.

**Statement of Cash Flows**

The statement of cash flows is presented using the direct method, which reflects cash flows from operating, investing, non-capital and capital financing activities.

**Kentucky Higher Education Student Loan Corporation**  
**Management's Discussion and Analysis**  
**(Unaudited)**

**FINANCIAL ANALYSIS OF THE CORPORATION**

The Corporation's total net assets at June 30, 2003 were approximately \$84 million, which is an increase of approximately \$5 million or 6 % over June 30, 2002. Components of the Corporation's balance sheet as of June 30, 2003 and 2002 were as follows:

<b>Net Asset Information</b>				
<b>June 30, 2003 and 2002</b>	<b>2003</b>	<b>2002</b>	<b>Inc/(Decr)</b>	<b>%</b>
Loans	\$ 806,743,657	\$ 716,068,985	\$90,674,672	13%
Capital Assets	2,244,707	1,510,176	734,531	49%
Other Assets	<u>326,781,755</u>	<u>181,870,363</u>	<u>144,911,392</u>	80%
<b>Total Assets</b>	<b>\$ 1,135,770,119</b>	<b>\$ 899,449,524</b>	<b>\$236,320,595</b>	26%
<b>Liabilities and Net Assets</b>				
Short and Long-term debt	\$ 1,023,050,000	\$ 788,770,000	\$234,280,000	30%
Other Liabilities	<u>29,131,862</u>	<u>32,079,637</u>	<u>(2,947,775)</u>	(9%)
<b>Total Liabilities</b>	<b><u>1,052,181,862</u></b>	<b><u>820,849,637</u></b>	<b><u>231,332,225</u></b>	28%
<b>Net Assets</b>				
Invested in Capital Assets	2,244,707	1,510,176	734,531	49%
Restricted	69,988,080	64,519,506	5,468,574	8%
Unrestricted	<u>11,355,470</u>	<u>12,570,205</u>	<u>(1,214,735)</u>	(10%)
<b>Total Net Assets</b>	<b><u>83,588,257</u></b>	<b><u>78,599,887</u></b>	<b><u>4,988,370</u></b>	6%
<b>Total Liabilities and Net Assets</b>	<b>\$ 1,135,770,119</b>	<b>\$ 899,449,524</b>	<b>\$ 236,320,595</b>	26%

The increase noted above in the Corporation's total assets is the continuation of a trend of growth in prior years. Total assets grew from approximately \$900 million at June 30, 2002 to approximately \$1.136 billion at June 30, 2003. Net loans outstanding totaled \$807 at June 30, 2003, a \$91 million increase over June 30, 2002. This increase included \$251 million in loan acquisitions (both originations and purchases) offset by borrower payments, consolidation loan payments and principal forgiveness. Other assets increased by \$145 million as a result of increased cash, cash equivalents and investments due to the issuance of additional bonds. During fiscal year 2003, the Corporation completed two debt issuances, the Series 2002 A-1, A-2 and A-3 bonds in the form of auction rate securities totaling approximately \$150 million and the Series 2003A, 2003B, 2003A-1 and 2003A-2 in the form of fixed rate and auction rate securities totaling approximately \$121 million. These debt issuances were offset by approximately \$37 million in bond maturities. This increase was the largest component of the Corporation's increase in its total liabilities. Other liabilities decreased \$2.9 million primarily as a result of a decrease in the allowance for arbitrage liabilities of \$6.8 million offset by an increase in accounts payable, accrued expenses and the due to KHEAA of \$3.9 million primarily due to increased default aversion and servicing activities.

**Kentucky Higher Education Student Loan Corporation**  
**Management's Discussion and Analysis**  
**(Unaudited)**

The Corporation's change in net assets for the year ended June 30, 2003 was \$5 million, which is a decrease of approximately \$5 million or 48% less than the change in net assets for the year ended June 30, 2002. Components of the Corporation's statement of revenues, expenses and changes in net assets for the years ended June 30, 2003 and 2002 were as follows:

**Revenues, Expenses and Changes in Net Assets Data**  
**Years ended June 30, 2003 and 2002**

	<b>2003</b>	<b>2002</b>	<b>Inc/(Decr)</b>	<b>%</b>
<b>Revenues:</b>				
Loan Interest Income	\$ 38,595,613	\$ 47,738,650	\$ (9,143,037)	(19%)
Investment Interest Income	<u>3,122,183</u>	<u>4,853,260</u>	<u>(1,731,077)</u>	(36%)
Total Interest Income	41,717,796	52,591,910	(10,874,114)	(21%)
Fee Income	<u>7,066,613</u>	<u>3,777,722</u>	<u>3,288,891</u>	87%
<b>Total Revenues</b>	<b><u>48,784,409</u></b>	<b><u>56,369,632</u></b>	<b><u>(7,585,223)</u></b>	(13%)
<b>Expenses:</b>				
Interest Expense on Debt	17,428,209	22,626,945	(5,198,736)	(23%)
(Reduction in)/Provision for				
Arbitrage Liabilities	(6,641,872)	4,810,982	(11,452,854)	(238%)
Principal Forgiveness	<u>5,514,745</u>	<u>-</u>	<u>5,514,745</u>	100%
Other Operating Expenses:				
Financing and Origination Fees	5,738,785	3,572,160	2,166,625	61%
Federal Consolidation Fees	1,739,581	1,307,673	431,908	33%
Personnel and Professional Services	8,038,764	5,964,854	2,073,910	35%
Technical Services	1,538,333	966,062	572,271	59%
General Administration	<u>7,439,494</u>	<u>4,471,961</u>	<u>2,967,533</u>	66%
Total Other Operating Expenses	<u>24,494,957</u>	<u>16,282,710</u>	<u>8,212,247</u>	50%
<b>Total Expenses</b>	<b><u>40,796,039</u></b>	<b><u>43,720,637</u></b>	<b><u>(2,924,598)</u></b>	(7%)
<b>Change in Net Assets before</b>				
<b>Operating Transfers</b>	7,988,370	12,648,995	(4,660,625)	(37%)
<b>Transfer to Other Funds:</b>				
Transfer to the Authority	<u>(3,000,000)</u>	<u>(3,000,000)</u>	<u>-</u>	(0%)
<b>Change in Net Assets</b>	<b><u>\$ 4,988,370</u></b>	<b><u>\$ 9,648,995</u></b>	<b><u>\$ (4,660,625)</u></b>	(48%)

Interest Income, which includes interest on loans and investments, decreased by 21% due to the declining interest rates in fiscal year 2003 and yield reductions related to interest forgiveness of approximately \$2.3 million. The average yield from interest on loans was 4.26% versus 6.32% in fiscal year 2002. Likewise, investment yields declined from 2.54% in fiscal year 2002 to 1.33% in fiscal year 2003. Fee income increased due to growth of a portfolio for a large client for whom the Corporation performs third-party servicing activities. Interest on debt decreased by 23% due to declining interest rates on the variable rate bonds outstanding. Average rates declined from 2.79% in fiscal year 2002 to 1.87% in fiscal year 2003. The expense related to the provision for arbitrage liabilities decreased approximately \$11.5 million due to borrower benefits given to certain borrowers in the portfolio. Borrower benefits were awarded in the form of loan and interest forgiveness of approximately \$7.9 million, which reduced the excess yield on certain of the Corporation's outstanding bond obligations by \$7.9 million and had a corresponding reduction in the provision for arbitrage liabilities.

**Kentucky Higher Education Student Loan Corporation**  
**Management's Discussion and Analysis**  
**(Unaudited)**

Other operating expenses increased 50% due to costs related to the growing loan portfolio as the Corporation adds loan volume, a change in an accounting estimate and a significant increase in the provision for servicing loan losses.

During the year ended June 30, 2003 the Corporation revised its estimate of the economic life over which loan origination costs are amortized from eleven to eight years. A charge of \$1.4 million was taken to reflect this change in accounting estimate. The provision for servicing loan losses increased by approximately \$880,000 due to additional servicing errors made by the Corporation on private loans that the Corporation services which are owned by a third party. Due to these servicing errors the Corporation was required to purchase these uninsured private loans.

**CONDITIONS AFFECTING FINANCIAL POSITION:**

At June 30, 2003, the Corporation was servicing and committed to purchase student loans from other lenders with a principal balance of approximately \$68 million. The total portfolio of student loans that the Corporation owns, services for other lenders, and collects was approximately \$4.2 billion at June 30, 2003. This is an increase of approximately \$1.2 billion or 39% higher than as of June 30, 2002.

The Corporation continues to experience significant growth in all aspects of its operations and the Corporation's fiscal year 2004 budget reflects continued growth. Efforts to increase the Corporation's lending market share in the Commonwealth of Kentucky and the continued high rate of growth in the client servicing portfolio is expected to promote the sustained growth pattern for the Corporation throughout the coming fiscal year. The Corporation has added additional staff to perform the additional work associated with this significant growth and the fiscal year 2004 budget reflects the additional costs expected to be incurred as a result of the increased student loan volume.

Lower market interest rates at June 30, 2003 will result in lower student loan interest rates (that reset every July 1) on outstanding student loans for fiscal year 2004, which will result in a reduction in the average yield for the total student loan portfolio.

Available and affordable funds from debt financings enable the Corporation to meet its lending demand for loans originated and purchased. Historically, the Corporation has issued primarily tax-exempt debt. However, since 1997 the Corporation has supplemented its tax-exempt funding with taxable debt at a higher interest cost. Annually, the Corporation receives an allocation from the Commonwealth's Private Activity Bond Allocation committee which allocates the amount of tax-exempt debt that the Corporation is authorized to issue. The Series 2002A-1, A-2 and A-3 were issued in the amount of \$110,900,000 as taxable bonds and \$39,100,000 as tax-exempt bonds. In May 2003, the Corporation with its annual allocation, carryforward from the previous year, and current refundings issued \$121,250,000 in tax-exempt debt. In July of 2003, the Corporation was allocated an additional \$11 million in authority to issue tax-exempt debt. The Corporation will utilize this additional allocation in fiscal year 2004 by issuing additional tax-exempt bonds.



**Kentucky Higher Education Student Loan Corporation**  
**Management's Discussion and Analysis**  
**(Unaudited)**

In addition to funds provided by the debt issuances, the Corporation also has access to a \$100 million line of credit for loan acquisitions. This line of credit provides additional liquidity in the event that loan demand exceeds the available funds from debt issuances. The Corporation has secured this line of credit through December 31, 2004 and expects to renew or replace this funding source to ensure available funds throughout fiscal year 2004. The Corporation and its trustee monitor the maturities of all debt instruments and the appropriate levels in the debt service and debt service reserve accounts. \$18.8 million in bonds will mature during fiscal year 2004 and \$56.9 million in bonds will mature in fiscal year 2005. The Corporation expects its student loan payment stream to provide adequate cash flows to meet its debt service requirements.

**Kentucky Higher Education Student Loan Corporation**  
**Balance Sheet**  
June 30, 2003

	Education Finance Funds				
	1983 General Bond Resolution	1997 General Bond Resolution	Line of Credit	Operating Fund	Combined Totals
<b>Assets</b>					
Current Assets:					
Cash and Cash Equivalents	\$ 62,525,961	\$ 12,271,170	\$ 205,736	\$ 6,272,647	\$ 81,275,514
Investments				6,385,176	6,385,176
Accounts Receivable and Prepaid Expenses	617	484,230		1,672,564	2,157,411
Accrued Interest Receivable	2,787,812	14,439,091	189	4,740	17,231,832
Special Allowance Receivable	1,147,593	8,512			1,156,105
Interfund Receivable (Payable)	235,147	(1,413,456)	(159,197)	1,337,506	
Total Current Assets	66,697,130	25,789,547	46,728	15,672,633	108,206,038
Noncurrent Assets:					
Loans, Net	143,855,602	662,888,055			806,743,657
Cash and Cash Equivalents	22,213,690	182,223,947			204,437,637
Deferred Debt Issuance Costs	838,471	4,085,793			4,924,264
Deferred Loan Purchase Premiums and Origination Costs, Net	519,704	8,694,112			9,213,816
Property, Plant and Equipment, Net				2,244,707	2,244,707
Total Noncurrent Assets	167,427,467	857,891,907		2,244,707	1,027,564,081
<b>Total Assets</b>	<b>\$ 234,124,597</b>	<b>\$ 883,681,454</b>	<b>\$ 46,728</b>	<b>\$ 17,917,340</b>	<b>\$ 1,135,770,119</b>
<b>Liabilities</b>					
Current Liabilities:					
Accounts Payable and Accrued Expenses	\$ 285,800	\$ 2,041,270	\$ 19,740	\$ 3,288,193	\$ 5,635,003
Interest Payable	367,072	908,047	26,988		1,302,107
Bonds/Note Payable	18,880,000				18,880,000
Due to KHEAA				1,028,970	1,028,970
Total Current Liabilities	19,532,872	2,949,317	46,728	4,317,163	26,846,080
Noncurrent Liabilities:					
Bonds/Note Payable	148,520,000	855,650,000			1,004,170,000
Allowance for Arbitrage Liabilities	18,907,467	2,258,315			21,165,782
Total Noncurrent Liabilities	167,427,467	857,908,315			1,025,335,782
<b>Total Liabilities</b>	<b>186,960,339</b>	<b>860,857,632</b>	<b>46,728</b>	<b>4,317,163</b>	<b>1,052,181,862</b>
<b>Net Assets:</b>					
Invested in Capital Assets				2,244,707	2,244,707
Restricted	47,164,258	22,823,822			69,988,080
Unrestricted				11,355,470	11,355,470
<b>Total Net Assets</b>	<b>47,164,258</b>	<b>22,823,822</b>		<b>13,600,177</b>	<b>83,588,257</b>
<b>Total Liabilities and Net Assets</b>	<b>\$ 234,124,597</b>	<b>\$ 883,681,454</b>	<b>\$ 46,728</b>	<b>\$ 17,917,340</b>	<b>\$ 1,135,770,119</b>

The accompanying notes are an integral part of the financial statements.

**Kentucky Higher Education Student Loan Corporation**  
**Statement of Revenues, Expenses, and Changes in Net Assets**  
Year ended June 30, 2003

	Education Finance Funds				
	1983 General Bond Resolution	1997 General Bond Resolution	Line of Credit	Operating Fund	Combined Totals
<b>Revenues:</b>					
Interest Income:					
Loans	\$ 6,165,094	\$ 27,268,432			\$ 33,433,526
Special Allowance	4,955,421	206,666			5,162,087
Investments	945,977	1,969,076	\$ 66,737	\$ 140,393	3,122,183
Debt Recovery Commission/Cost Reimbursemen				2,307,152	2,307,152
Servicing Fees				4,759,461	4,759,461
<b>Total Revenues</b>	<b>12,066,492</b>	<b>29,444,174</b>	<b>66,737</b>	<b>7,207,006</b>	<b>48,784,409</b>
<b>Expenses:</b>					
Interest on Debt	5,576,810	11,725,982	125,417		17,428,209
Principal Forgiveness	5,514,745				5,514,745
Amortization of Bond Issuance Costs	193,528	136,767			330,295
Variable Bond Credit Facility and Remarketing Fees	225,258	1,988,369	86,422		2,300,049
(Reduction in)/Provision for Arbitrage Liabilities	(7,863,189)	1,221,317			(6,641,872)
Amortization of Loan Purchase Premiums and Origination Costs	350,233	2,758,208			3,108,441
Depreciation and Amortization	157,178	311,500		446,970	915,648
Federal Consolidation Fees	542,621	1,196,960			1,739,581
Personnel and Professional Services	1,611,697	2,654,288	1,140	3,771,639	8,038,764
Technical Services	210,167	416,517		911,649	1,538,333
General Administrative Expenses	603,462	1,193,973		1,786,815	3,584,250
Provision for Student Loan Losses	(57,539)	206,172		1,180,998	1,329,631
Other Expenses	347,335	925,256	27,597	309,777	1,609,965
<b>Total Expenses</b>	<b>7,412,306</b>	<b>24,735,309</b>	<b>240,576</b>	<b>8,407,848</b>	<b>40,796,039</b>
<b>Operating Income (loss)</b>	<b>4,654,186</b>	<b>4,708,865</b>	<b>(173,839)</b>	<b>(1,200,842)</b>	<b>7,988,370</b>
Interfund Transfer	(750,000)		29,362	720,638	
Transfer to the Kentucky Higher Education Assistance Authority	(3,000,000)			0	(3,000,000)
<b>Increase (decrease) in Net Assets</b>	<b>904,186</b>	<b>4,708,865</b>	<b>(144,477)</b>	<b>(480,204)</b>	<b>4,988,370</b>
Net Assets at Beginning of Year	46,260,072	18,114,957	144,477	14,080,381	78,599,887
<b>Net Assets at End of Year</b>	<b>\$ 47,164,258</b>	<b>\$ 22,823,822</b>	<b>\$ -</b>	<b>\$ 13,600,177</b>	<b>\$ 83,588,257</b>

The accompanying notes are an integral part of the financial statements.

**Kentucky Higher Education Student Loan Corporation**  
**Statement of Cash Flows**  
Year ended June 30, 2003

	<b>Education Finance Funds</b>				
	<b>1983 General Bond Resolution</b>	<b>1997 General Bond Resolution</b>	<b>Line of Credit</b>	<b>Operating Fund</b>	<b>Combined Totals</b>
<b>Cash Flows from Operating Activities:</b>					
Principal Received on Loans	\$ 38,951,254	\$ 119,625,989			\$ 158,577,243
Interest on Loans	6,630,437	19,054,174			25,684,611
Special Allowance	4,789,771	198,425			4,988,196
Client Loan Receipts				\$ 644,205,336	644,205,336
Servicing Fees				3,512,241	3,512,241
Debt Recovery Commission/Cost Reimbursement				2,327,778	2,327,778
Loans Purchased, including Premiums	80	(57,325,167)		(1,021,130)	(58,346,217)
Loans Originated, including Costs	(19,667,499)	(173,117,454)			(192,784,953)
Credit Facility Fees	(224,127)	(1,899,563)	\$ (87,572)		(2,211,262)
Loan Receipts Remitted to Clients				(644,001,717)	(644,001,717)
Other Expenses	(4,380,051)	(6,265,996)	107,074	(2,878,221)	(13,417,194)
<b>Net Cash Provided by (Used in) Operating Activities</b>	<b>26,099,865</b>	<b>(99,729,592)</b>	<b>19,502</b>	<b>2,144,287</b>	<b>(71,465,938)</b>
<b>Cash Flows from Investing Activities:</b>					
Investment Income Received	1,009,905	1,908,699	66,828	142,082	3,127,514
Proceeds from Sales and Maturities of Investments	60,756,675			17,300,000	78,056,675
Purchases of Investments	(24,451,765)			(16,511,789)	(40,963,554)
<b>Net Cash Provided by Investing Activities</b>	<b>37,314,815</b>	<b>1,908,699</b>	<b>66,828</b>	<b>930,293</b>	<b>40,220,635</b>
<b>Cash Flows from Noncapital Financing Activities:</b>					
Proceeds from Debt Issued	40,600,000	230,650,000	11,495,000		282,745,000
Debt Issuance Costs	(188,918)	(958,854)			(1,147,772)
Debt Principal Payments	(36,970,000)		(11,495,000)		(48,465,000)
Interest on Debt	(5,697,697)	(11,631,494)	(98,429)		(17,427,620)
Interfund Transfer	(750,000)		29,362	720,638	0
Transfer to the Authority	(3,000,000)				(3,000,000)
<b>Net Cash Provided by (Used in) Noncapital Financing Activities</b>	<b>(6,006,615)</b>	<b>218,059,652</b>	<b>(69,067)</b>	<b>720,638</b>	<b>212,704,608</b>
<b>Cash Flows from Capital and Related Financing Activities</b>					
Property, Plant and Equipment Acquired				(1,736,682)	(1,736,682)
<b>Net Cash Used in Capital and Related Financing Activities</b>				<b>(1,736,682)</b>	<b>(1,736,682)</b>
Net Increase in Cash and Cash Equivalents	57,408,065	120,238,759	17,263	2,058,536	179,722,623
Cash and Cash Equivalents at Beginning of Yea	27,331,586	74,256,358	188,473	4,214,111	105,990,528
<b>Cash and Cash Equivalents at End of Year</b>	<b>\$ 84,739,651</b>	<b>\$ 194,495,117</b>	<b>\$ 205,736</b>	<b>\$ 6,272,647</b>	<b>\$ 285,713,151</b>

The accompanying notes are an integral part of the financial statements.

**Kentucky Higher Education Student Loan Corporation**  
**Reconciliation of Operating Income to Net Cash Provided by (Used In) Operating Activities**

Year ended June 30, 2003

	<b>Education Finance Funds</b>				
	<b>1983 General Bond Resolution</b>	<b>1997 General Bond Resolution</b>	<b>Line of Credit</b>	<b>Operating Fund</b>	<b>Combined Totals</b>
<b>Operating Income (loss)</b>	<b>\$ 4,654,186</b>	<b>\$ 4,708,865</b>	<b>\$ (173,839)</b>	<b>\$ (1,200,842)</b>	<b>\$ 7,988,370</b>
Income and Expense Items not Affecting Cash Provided by (Used in) Operating Activities:					
Investment Income	(945,977)	(1,969,076)	(66,737)	(140,393)	(3,122,183)
Depreciation and Amortization	157,178	311,500		446,970	915,648
Loss on Equipment Disposal				86,504	86,504
Amortization of Bond Issuance Costs	193,528	136,767			330,295
Amortization of Loan Purchase Premiums and Origination Costs	350,233	2,758,208			3,108,441
Interest on Debt	5,576,810	11,725,982	125,417		17,428,209
Provision for Loan Losses	(57,539)	206,172		1,180,998	1,329,631
Borrower Interest Converted to Principal	(489,754)	(8,979,793)		(4,480)	(9,474,027)
Principal Forgiveness	5,514,745				5,514,745
Net Change in Fair Value of Investments	31,018			1,944	32,962
Other	(225,504)	(381,978)	(91)	311,600	(295,973)
Items Not Accounted for as Revenues or Expenses:					
Principal Received on Loans	38,951,254	119,625,988			158,577,242
Loans Purchased, including Premiums	80	(57,325,167)		(1,021,130)	(58,346,217)
Loans Originated, including Costs	(19,667,499)	(173,117,454)			(192,784,953)
(Increase) Decrease in Assets:					
Accounts Receivable and Prepaid Expenses	16,990	(413,791)		(861,874)	(1,258,675)
Accrued Interest	1,000,057	705,158	91	(255)	1,705,051
Special Allowance Receivable	(165,650)	(8,241)			(173,891)
Interfund Receivable/Payable	(922,336)	(189,554)	135,810	976,080	
Increase (Decrease) in Liabilities:					
Accounts Payable and Accrued Expenses	(7,952)	1,432,908	(1,149)	1,402,344	2,826,151
Due to KHEAA				966,821	966,821
Allowance for Arbitrage Liabilities	(7,864,003)	1,043,914			(6,820,089)
<b>Net Cash Provided by (Used in) Operating Activities</b>	<b>\$ 26,099,865</b>	<b>\$ (99,729,592)</b>	<b>\$ 19,502</b>	<b>\$ 2,144,287</b>	<b>\$ (71,465,938)</b>

The accompanying notes are an integral part of the financial statements.

## Kentucky Higher Education Student Loan Corporation

### Notes to Financial Statements

#### (1) Description of Business and General Bond Resolutions

The Kentucky Higher Education Student Loan Corporation (Corporation) is an independent *de jure* municipal corporation established by the Kentucky General Assembly in 1978 to provide a loan finance program for post-secondary students in the Commonwealth of Kentucky. Governed by a Board of Directors, the Corporation is authorized to finance loans for students attending eligible post-secondary institutions, service and collect education loans, and issue bonds and notes not to exceed \$1,950 million in order to carry out its corporate powers and duties. The Corporation's education finance, servicing and collection activities include: (i) the origination and secondary market acquisition of education loans originated pursuant to the Federal Family Education Loan Program (FFELP); (ii) the financing of FFELP Loans; (iii) the servicing of FFELP Loans and of other education loans, and (iv) the collection of FFELP Loans and other education loans for other holders on a commission or cost reimbursement basis. The FFELP student loans held, serviced and collected by the Corporation include Federal Stafford Loans (Stafford), Unsubsidized Stafford Loans (Unsubsidized Stafford), Federal Supplemental Loans for Students (SLS), Federal Parent Loans for Undergraduate Students (PLUS), and Federal Consolidation Loans (Consolidations).

The FFELP loans held by the Corporation are insured by the Kentucky Higher Education Assistance Authority (Authority), as the state guarantee agency, or the U. S. Department of Education (USDE). Loans made prior to October 1, 1993, are 100% insured. Loans made on or after October 1, 1993, are 100% insured against borrowers' death, disability, or bankruptcy and 98% insured against borrowers' default.

The Corporation's General Bond Resolutions (GBRs) and separate Series Resolutions for issue of revenue bonds contain provisions establishing funds and accounts for the segregation of assets and provisions restricting the use of the proceeds of bonds and other funds received.

As of June 30, 2003 the Corporation held approximately \$807 million outstanding principal amount of FFELP Loans which are pledged pursuant to the 1983 GBR, the 1997 GBR or the Line of Credit Trust Agreement and serviced approximately \$3.3 billion of FFELP Loans and other education loans on behalf of other holders, including holders with national lending operations. The majority of such education loans are being serviced by the Corporation pursuant to servicing agreements which do not provide for the acquisition by the Corporation of the education loans serviced, except in cases of servicing due diligence violations. As a servicer of FFELP loans, the Corporation collects student loan remittances and subsequently disburses these remittances to the appropriate lending entities. In addition, the Corporation currently collects approximately \$172 million of FFELP Loans and other education loans for other holders on a commission or cost reimbursement basis. The Corporation's obligations pursuant to such servicing and collection agreements are without recourse to assets pledged to collateralize any Corporation financings.

## **Kentucky Higher Education Student Loan Corporation**

### **Notes to Financial Statements**

#### **(2) Summary of Significant Accounting Policies**

##### **(a) Reporting Entity**

The Corporation is a component unit agency of the Authority (a component unit of the Commonwealth of Kentucky). The accompanying financial statements include only the net assets, changes in net assets and cash flows of the Corporation.

Prior to July 1, 2003, the Corporation was a component agency unit of the Commonwealth of Kentucky and accordingly was reported in the Commonwealth of Kentucky Comprehensive Annual Financial Report. The change in reporting entity did not have an impact on reported operating income or changes in net assets.

##### **(b) Basis of Presentation**

The Corporation's basic financial statements are prepared in accordance with Governmental Accounting Standards Board (GASB) Statement No. 34, "Basic Financial Statements and Management Discussion and Analysis - for State and Local Governments" (GASB 34). The basic financial statements are comprised of fund financial statements and notes to the financial statements. The fund financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America applicable to state government entities, which provide that financial activities operated similarly to private business enterprises be presented as separate proprietary funds and that accounting results be organized by funds to account for specific activities consistent with legal and operating requirements. The Corporation's funds include the Education Finance Funds and the Operating Fund. The Education Finance Funds include loan programs funded individually under financings under the 1983 General Bond Resolution, the 1997 General Bond Resolution and the Line of Credit.

Financial activities operated similarly to private business enterprises and financed through fees for servicing and defaulted loan collection are presented under the Operating Fund. The Corporation follows all applicable GASB pronouncements, as well as Financial Accounting Standards Board pronouncements and Accounting Principles Board Opinions issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. The Corporation uses the accrual basis of accounting.

##### **(c) Loan Losses**

As discussed in Note 1, the Corporation's FFELP loans are guaranteed by the Authority. Management of the Corporation believes that the Authority will be able to honor all default claims submitted by the Corporation. However, the Corporation records a provision for loan losses based upon its expected default claims with respect to 98% insured loans and for loans with certain loan servicing violations. The allowance for loan losses on FFELP loans was \$780,686 for loan principal and \$116,494 for accrued interest as of June 30, 2003. Additionally, the Corporation is required to purchase loans owned by third party customers with certain loan servicing violations. As of June 30, 2003, the allowance for loan losses on loans purchased from third party servicing clients was \$1,062,219 for principal and \$43,931 for accrued interest.

## Kentucky Higher Education Student Loan Corporation

### Notes to Financial Statements

#### (2) Summary of Significant Accounting Policies (continued)

##### (d) Investments

Investments, which consist principally of securities of the federal government or its agencies and commercial paper, are reported at fair market value. Fair market value is determined by using quoted market prices as of the last day of the fiscal year.

##### (e) Interest Income on Loans

The Corporation earns interest income on loans from three sources: (1) the USDE for subsidized interest earned while certain students are in school; (2) special allowance subsidies (discussed in Footnote 6); and (3) the borrowers. All interest is recorded when earned and is shown in the financial statements net of the interest related portion of the provision for loan losses.

##### (f) Commission on Debt Recovery

The Corporation's fee for collection of defaulted education loans is recorded as commission revenue when earned. Loans for which the Corporation performs debt recovery services are not presented on the balance sheet as they are not owned by the Corporation.

##### (g) Servicing Fees

The Corporation's fees for servicing loans held by third parties are recorded as servicing fee revenue when earned. These third-party loans are not presented on the balance sheet as they are not owned by the Corporation.

##### (h) Income Taxes

The Corporation is an independent *de jure* municipal corporation and political subdivision of the Commonwealth of Kentucky and is therefore not subject to federal or state income taxes.

##### (i) Deferred Bond Issuance Costs

Bond issuance costs are deferred and amortized over the life of the bonds, utilizing the bonds outstanding method, which approximates the effective interest method.

##### (j) Deferred Loan Purchase Premiums and Deferred Loan Origination Costs

Loan purchase premiums and certain origination costs are deferred and amortized over the estimated life of the loans acquired or originated, based on projected balances outstanding, which approximates the effective interest method.



# Kentucky Higher Education Student Loan Corporation

## Notes to Financial Statements

### (2) Summary of Significant Accounting Policies (continued)

#### (k) Interfund Eliminations

Receivables and payables among the funds of the Corporation are eliminated in the balance sheet.

#### (l) Property, Plant and Equipment

Office furnishings, equipment, and system development costs are recorded at cost and depreciated over their estimated useful lives using the straight-line method.

#### (m) Statement of Cash Flows

For the statement of cash flows, the Corporation considers cash and cash equivalents to include money market funds and highly liquid investments which mature within one month of purchase.

#### (n) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

### (3) Cash, Cash Equivalents and Investments

Cash, cash equivalents and investments as of June 30, 2003, are summarized below:

Cash	\$ 3,406,883
Cash Equivalents	282,306,268
Investments	<u>6,385,176</u>
Total Cash, Cash Equivalents and Investments	<u>\$ 292,098,327</u>

Deposits, identified as cash in the above summary, are as follows as of June 30, 2003:

	Financial Statement Amount	Bank Balance
Insured (FDIC)	\$ 200,000	\$ 200,000
Collateralized	90,671	90,671
Uninsured and uncollateralized	<u>3,116,212</u>	<u>3,609,200</u>
Total Deposits	<u>\$ 3,406,883</u>	<u>\$ 3,899,871</u>

Pursuant to GASB 34, restricted assets are to be classified according to their anticipated release from restriction, accordingly, \$204,437,637 cash and cash equivalents are classified as noncurrent assets.

# Kentucky Higher Education Student Loan Corporation

## Notes to Financial Statements

### (3) Cash, Cash Equivalents and Investments (continued)

The following is a summary of investments, including cash equivalents, categorized as of June 30, 2003:

	<u>Category 1</u>	<u>Uncategorized</u>	<u>Total</u>
U.S. Treasury and Government Agency Obligations	\$ 6,820,271		\$ 6,820,271
Government Mutual Funds		\$ 89,329,970	89,329,970
Money Market Securities		192,541,203	192,541,203
Total Investments	<u>\$ 6,820,271</u>	<u>\$ 281,871,173</u>	<u>\$ 288,691,444</u>

The Corporation's investments are categorized according to the level of credit risk assumed by the Corporation. Category 1 Investments include investments that are insured, registered, or for which the securities are held by the Corporation or its agent in the Corporation's name.

### (4) Loans

The Corporation originates, purchases and holds various types of student loans as described in Note 1. The terms of these loans, which vary on an individual basis depending upon loan type and the date the loan was originated, generally provide for repayment in monthly installments of principal and interest over a period of up to thirty years for Consolidation loans and generally up to ten years for other loans. The repayment period begins after a grace period of six months following graduation or loss of qualified student status for the Subsidized and Unsubsidized Stafford loans. The repayment period for Consolidation, SLS and PLUS loans begins within 60 days from the date the loan is fully disbursed. Interest rates on student loans ranged from 3.46% to 12% for the fiscal year ended June 30, 2003 depending upon the type and date of origination of the individual loan.

Loans consist of the following at June 30, 2003:

Stafford – Subsidized	\$361,245,902
Stafford – Unsubsidized	239,988,375
PLUS/SLS	20,194,524
Consolidation	186,080,977
Other	1,076,784
Total gross loans	<u>808,586,562</u>
Allowance for loan loss	<u>(1,842,905)</u>
Net loans	<u>806,743,657</u>
Net deferred premium and loan cost	<u>9,213,816</u>
Net Loans and deferred premium and loan costs	<u>\$815,957,473</u>

All student loans are guaranteed as to principal and accrued interest. In order for the loans to be or remain guaranteed, certain due diligence requirements in loan servicing must be met. As of June 30, 2003, \$2,674,055 of student loans were no longer considered guaranteed due to violation of due diligence requirements.

# Kentucky Higher Education Student Loan Corporation

## Notes to Financial Statements

### (4) Loans (continued)

The Corporation withholds certain origination fees from the loan disbursements on FFELP loans to the borrowers and remits these fees to USDE. The amount of the origination fees is based on a percentage of the gross loan amount.

The Corporation is also required to pay to USDE certain Lender and Rebate Fees. The amount of the Lender Fees is based on a certain percentage of the gross loan amount on all FFELP loans originated after October 1, 1993 and a certain percentage of the carrying value of the Consolidation loans.

Loan origination costs are capitalized when the loan is made and are amortized; using the projected balances outstanding method which approximates the effective interest method, over the estimated economic life of the loan. Purchase premiums are capitalized and amortized in the same manner. The capitalized loan origination costs and purchase premiums, net of accumulated amortization, at June 30, 2003, were approximately \$9,213,816.

During the year ended June 30, 2003 the Corporation revised its estimate of the economic life over which loan origination costs and purchase premiums are amortized from eleven to eight years. A charge of \$1,412,568 was taken to reflect this change in accounting estimate.

Generally, student loans of the Corporation are pledged as collateral for the various obligations of the Corporation.

### (5) Property, Plant and Equipment

A summary of Property, Plant and Equipment follows:

	Beginning Balance July 1, 2002	Additions	Disposals	Ending Balance June 30, 2003
Furniture	\$ 955,009	\$ 496,349	\$ (38,730)	\$ 1,412,628
Computer Equipment	2,614,934	1,237,350	(310,422)	3,541,862
Other Equipment	197,774	2,983	(13,172)	187,585
System Development – Information Services	55,955			55,955
Student Loan servicing System	541,131			541,131
Debt Recovery System	139,350			139,350
Tuition Line Servicing System	<u>16,922</u>	<u>-</u>	<u>(16,922)</u>	<u>-</u>
Total Property, Plant and Equipment	\$ 4,521,075	\$ 1,736,682	\$ (379,246)	\$ 5,878,511
Less Accumulated Depreciation	<u>3,010,899</u>	<u>915,648</u>	<u>(292,743)</u>	<u>3,633,804</u>
Net Property, Plant and Equipment	<u>\$ 1,510,176</u>	<u>\$ 821,034</u>	<u>\$ (86,503)</u>	<u>\$ 2,244,707</u>

## **Kentucky Higher Education Student Loan Corporation**

### **Notes to Financial Statements**

#### **(6) Special Allowance**

The U.S. Department of Education pays a special allowance to the Corporation after the end of each quarter representing supplemental interest on outstanding, insured loans. FFELP loans disbursed during the period from January 1, 2000 through June 30, 2003, receive special allowance at a rate based upon the average of the bond equivalent rates of the 3-month commercial paper rate as reported by the U.S. Federal Reserve. Other eligible loans receive special allowance based on the 91-day U.S. Treasury bill rates. Certain tax-exempt bonds issued prior to October 1, 1993 receive a floor rate of 9.50% on all student loans held in those issues.

#### **(7) Principal and Interest Forgiveness**

During fiscal year 2003, the Corporation initiated an incentive program to encourage higher education and certain high-need occupations in the Commonwealth of Kentucky. In connection with the program, the Corporation forgave \$5,514,745 in student loan principal and \$2,344,279 in accrued interest during the year ended June 30, 2003 to qualified borrowers. For accounting purposes, the forgiven interest is treated as a reduction in student loan interest revenue in the period of the award and forgiven student loan principal is recorded as an operating expense in the period of the award.

# Kentucky Higher Education Student Loan Corporation

## Notes to Financial Statements

### (8) Revenue Bonds

The balance of revenue bonds at June 30, 2003 and the related activity for the year ended June 30, 2003 is as follows (in thousands):

<u>Series</u>	<u>Scheduled Maturity</u>	<u>Interest Rate</u>	<u>Beginning Balance at July 1, 2002</u>	<u>Bond Maturities</u>	<u>New Issues</u>	<u>Ending Balance at June 30, 2003</u>
<b><u>1983 General Bond Resolution</u></b>						
1991 B	Semi-annually in various Amounts through June 1, 2004	6.80%	\$ 1,600	\$ (1,600)		-
1991 D	Semi-annually in various Amounts through December 1, 2011	6.75% to 7.10%	7,120	(7,120)		-
1991 E	December 1, 2011	Weekly	46,000			46,000
1993 B	Semi-annually in various Amounts through December 1, 2005	4.90% to 5.30%	75,800	(20,000)		55,800
1995 B	June 1, 2003	5.15%	750	(750)		-
1995 C	June 1, 2003	5.45%	3,000	(3,000)		-
1996 A	June 1, 2026	Weekly**	25,000			25,000
1996 B	June 1, 2003	5.15%	2,500	(2,500)		-
1997 B	June 1, 2003	5.15%	1,000	(1,000)		-
1997 D	June 1, 2003	5.40%	1,000	(1,000)		-
2003 A	December 1, 2032	Every 35 Days	-		20,600	20,600
2003 B	June 1, 2005	1.65%	-		20,000	20,000
<b><u>1997 General Bond Resolution</u></b>						
1997 A-1	May 1, 2027	Every 35 days**	45,250			45,250
1997 A-2	May 1, 2027	Every 35 days**	45,200			45,200
1997 B	May 1, 2027	Every 35 days**	44,550			44,550
1998 A-1	May 1, 2028	Every 28 days**	36,400			36,400
1998 A-2	May 1, 2028	Every 28 days**	36,400			36,400
1998 B	May 1, 2028	Every 35 days**	42,200			42,200
1999 A	May 1, 2029	Every 28 days**	51,350			51,350
1999 B	May 1, 2029	Every 35 days**	23,650			23,650
2000 A-1	May 1, 2030	Every 28 days**	42,100			42,100
2000 A-2	May 1, 2030	Every 28 days**	42,100			42,100
2000 A-3	May 1, 2030	Every 35 days**	42,050			42,050
2000 B	May 1, 2030	Every 35 days**	23,750			23,750
2001 A-1	May 1, 2031	Every 35 days**	59,850			59,850
2001 A-2	May 1, 2031	Every 35 days**	59,850			59,850
2001 B	May 1, 2031	Every 35 days**	30,300			30,300
2002 A-1	May 1, 2032	Every 28 days**	-		55,450	55,450
2002 A-2	May 1, 2032	Every 28 days**	-		55,450	55,450
2002 A-3	May 1, 2032	Every 35 days**	-		39,100	39,100
2003 A-1	May 1, 2033	Every 35 days**	-		63,700	63,700
2003 A-2	May 1, 2033	Every 35 days**	-		16,950	16,950
			<b>\$ 788,770</b>	<b>\$ (36,970)</b>	<b>\$ 271,250</b>	<b>\$1,023,050</b>

\*\* Variable interest rate changes based on specified indices.

All Revenue Bonds except for the Senior Series 1997-A-1 and 1997-A-2, Senior Series 1998A-1 and 1998A-2, Senior Series 1999A, and Senior Series 2000A-1, 2000A-2, and Senior Series 2000A-3 and Senior Series 2001A-1 and 2001A-2 and Senior Series 2002A-1 and 2002A-2 are tax-exempt issues.

# Kentucky Higher Education Student Loan Corporation

## Notes to Financial Statements

### (8) Revenue Bonds (continued)

Debt service requirements to maturity or redemption date, assuming interest rates on variable rate debt remains at June 30, 2003 levels, are as follows:

	Principal Repayment Amount (Thousands)		
	<u>83 GBR</u>	<u>97 GBR</u>	<u>Total</u>
Year Ending June 30, 2004	\$ 18,880		\$ 18,880
Year Ending June 30, 2005	56,920		56,920
Year Ending June 30, 2006			
Year Ending June 30, 2007			
Year Ending June 30, 2008			
5 Years Ending June 30, 2013	46,000		46,000
5 Years Ending June 30, 2018			
5 Years Ending June 30, 2023			
5 Years Ending June 30, 2028	25,000	\$ 135,000	160,000
5 Years Ending June 30, 2033	<u>20,600</u>	<u>720,650</u>	<u>741,250</u>
	<u>\$ 167,400</u>	<u>\$ 855,650</u>	<u>\$ 1,023,050</u>
	Interest Payments Amount (Thousands)		
	<u>83 GBR</u>	<u>97 GBR</u>	<u>Total</u>
Year Ending June 30, 2004	\$ 4,193	\$ 14,494	\$ 18,687
Year Ending June 30, 2005	3,133	14,494	17,627
Year Ending June 30, 2006	1,264	14,494	15,758
Year Ending June 30, 2007	1,264	14,494	15,758
Year Ending June 30, 2008	1,264	14,494	15,758
5 Years Ending June 30, 2013	5,368	72,470	77,838
5 Years Ending June 30, 2018	3,146	72,470	75,616
5 Years Ending June 30, 2023	3,146	72,470	75,616
5 Years Ending June 30, 2028	2,427	69,478	71,905
5 Years Ending June 30, 2033	<u>1,088</u>	<u>28,721</u>	<u>29,809</u>
	<u>\$ 26,293</u>	<u>\$ 388,079</u>	<u>\$ 414,372</u>

All assets of the 1983 General Bond Resolution Fund and 1997 General Bond Resolution Fund are pledged for repayment of the specific bond issues under each resolution.

### (9) Line of Credit

The Corporation is a party to a Line of Credit Agreement with Bank of America, N.A., providing for advances to the Corporation not to exceed an aggregate outstanding principal balance of \$100 million. The borrowing period ends December 31, 2004, and can be extended at the discretion of both parties through December 31, 2005. During the year ended June 30, 2003, the Corporation drew down \$11,495,000 and made principal payments of \$11,495,000 on this line of credit. At June 30, 2003, there were no advances outstanding.

## **Kentucky Higher Education Student Loan Corporation**

### **Notes to Financial Statements**

#### **(10) Allowance for Arbitrage Liabilities**

Certain of the Corporation's tax-exempt bond issues subject the Corporation to potential arbitrage liabilities under U.S. tax law. Arbitrage liabilities, under current federal income tax law regarding tax-exempt bond issues, consist of three types; (1) yield adjustment payments, (2) forgiveness and (3) arbitrage rebate. At June 30, 2003, the Corporation is reporting a liability for yield adjustment payments and forgiveness of \$20,733,427 and for arbitrage rebate of \$432,355. The determination of excess yield on acquired purpose investments is cumulative over the life of the applicable bond series, as is the determination of arbitrage rebate on non-purpose investments, except for variable rate bonds for which arbitrage rebate is generally determined for each five-year period without retroactivity.

Yield adjustment payments, which also relate to yield restriction on acquired purpose investments, are applicable to the 1991 Series D & E Bonds, 1996 Series A, Subordinate Series 1997-B, Senior Series 1998B, Senior Series 1999B, Senior Series 2000B, Senior Series 2001B, and any future issues except certain refunding issues. The allowable yield is 2% above the bond yield (arbitrage yield), with the federal special allowance included in income. The loss of tax-exempt status may be avoided by rebating the excess yield to the U.S. Treasury every 10 years, and upon final maturity of the bonds.

Forgiveness is applicable to the 1991 Series B & C, 1993 Series A, B & C, 1994 Series A & B, 1995 Series A, B & C, 1996 Series B, and 1997 Series A, B, C, & D bonds. In general, a yield restriction is imposed on acquired purpose investments, designating the allowable yield as 1.5% above the bond yield (arbitrage yield), with the federal special allowance excluded from income. The loss of tax-exempt status may be avoided by partial forgiveness of the applicable student loans. Forgiveness can be applied upon maturity of the bonds or as otherwise prescribed by the bond resolutions.

As discussed in Note 7, the Corporation instituted an incentive program to encourage higher education and certain high-need occupations in the Commonwealth of Kentucky. The Corporation has determined that benefits awarded under this program qualify as reductions to the excess yield on bonds subject to arbitrage restrictions. Accordingly, a reduction in the arbitrage liability of \$7.9 million was recorded during the year ended June 30, 2003 for awards under the incentive program.

Arbitrage rebate is applicable to all of the Corporation's tax-exempt bonds. With certain limited exceptions, income earned on non-purpose investments (investments other than student loans), which exceeds the bond yield (arbitrage yield), must be rebated to the U.S. Treasury. Payments of at least 90% are due every five years after the year of issuance, and upon final maturity of bonds.

## **Kentucky Higher Education Student Loan Corporation**

### **Notes to Financial Statements**

#### **(11) Credit and Liquidity Facilities and Bond Remarketing**

The 1991 Series E and 1996 A Bonds are collateralized with Standby Bond Purchase Agreements, pursuant to which Landesbank Hessen-Thüringen Girozentrale will purchase any bonds not remarketed. The 1991 Series E Bonds and the 1996 Series A Bonds also have a Municipal Bond Insurance Policy issued by AMBAC Indemnity Corporation and MBIA Insurance Corporation, respectively, which collateralizes payment of principal and interest on the bonds. The Standby Bond Purchase Agreements expires June 10, 2004, unless it is renewed, the AMBAC Municipal Bond Insurance Policy extends through the term of the 1991 Series E Bonds, December 1, 2011 and the MBIA Municipal Bond Insurance Policy extends through the term of the 1996 Series A Bonds, June 1, 2026.

The Corporation pays certain fees with respect to its variable rate bonds to auction agents, broker dealers, market agents, remarketing agents, and tender agents for remarketing bonds or conducting auctions of bonds. These arrangements are generally cancellable with prior notice by either party.

#### **(12) Retirement Plan**

The Corporation provides retirement benefits to all full-time employees through the Kentucky Retirement System (KRS). KRS is a multiple-employer, defined benefit plan sponsored by the Commonwealth of Kentucky, which provides retirement, disability, and death benefits. The Corporation contributed 5.89% of gross wages for the year ended June 30, 2003. The employees contributed 5% of their gross wages to the plan for the years ended June 30, 2003. Such rates are intended to provide for normal costs on a current basis, plus an amount equal to the amortization of unfunded past service costs over thirty years, using the level percentage of payroll method. These contribution rates are determined by the Board of Trustees of KRS each biennium. The payroll of employees covered by the retirement plan was \$6,078,186 for the year ended June 30, 2003. Total payroll for the year ended June 30, 2003 was \$6,595,596. KRS participants have fully vested interests after the completion of sixty months of service, twelve months of which are current service. The KRS contribution requirement for the year ended June 30, 2003 was \$661,922, which consisted of employer contributions of \$358,009 and \$303,913 from employees in 2003. Although separate measurements of assets and pension benefit obligation are not available for individual employers, KRS's annual financial report (which is a matter of public record) contains this information for KRS as a whole.



## **Kentucky Higher Education Student Loan Corporation**

### **Notes to Financial Statements**

#### **(13) Related Party Transactions**

During the year ended June 30, 2003, the Corporation incurred expenses of \$528,000 for technical services, \$1,008,843 for document processing services and \$281,620 for loan origination and disbursement services provided by the Authority.

Pursuant to a separate agreement, the Corporation collects certain defaulted student loans for the Authority. Fee revenue recognized with respect to loan collection services was \$152,245 and default collection cost reimbursement revenue was \$2,014,281 for the year ended June 30, 2003.

During the year ended June 30, 2003, Corporation employees performed services on behalf of the Authority valued at \$317,000 and Authority employees performed services on behalf of the Corporation valued at \$175,000.

At June 30, 2003, the aggregate net due to KHEAA was \$1,028,970.

The Corporation is a party to a contract with the Authority whereby the Corporation maintains custody of federally restricted funds on behalf of the Authority and disburses such funds under the direction of the Authority, in accordance with the federal restrictions, for default aversion activities. All disbursements under the contract require approval by the Authority. The Authority transferred \$444,623 to the Corporation during fiscal year 2003 under this agreement. As of June 30, 2003, the Corporation held undisbursed default aversion funds of \$1,503,131 on behalf of the Authority.

During the year ended June 30, 2003, the Corporation made transfers totaling \$3 million to the Authority for support of state student financial aid programs, as approved by the Corporation's Board of Directors, pursuant to Section 508(c) of the 1983 General Bond Resolution.

#### **(14) Net Assets**

Restricted net assets consist of net assets of the Education Finance Funds as required by the 1983 and 1997 General Bond Resolutions, the separate Series Resolutions, and Line of Credit Agreements. Pursuant to action of the Board of Directors, unrestricted net assets at June 30, 2003 includes \$11,443,877 less the amount invested in capital assets, representing a reservation of funds equal to one-half of the Corporation's budgeted operating expenses for the then upcoming fiscal year.

## **Kentucky Higher Education Student Loan Corporation**

### **Notes to Financial Statements**

#### **(15) Commitments and Contingencies**

The Corporation has entered into loan purchase contracts with various eligible lenders. Subject to the terms and conditions of these agreements, the Corporation on June 30, 2003, had plans to purchase approximately \$68 million of loans. These contracts cannot be terminated by either party.

The Corporation is a party to student loan servicing contracts with several third-party lenders. Under the terms of the contracts, should the corporation fail to meet minimum servicing due diligence criteria, the Corporation must purchase the affected loans at par value plus accrued interest. At June 30, 2003 the Corporation serviced loans with par value of approximately \$3,249,033,000 that were subject to servicing due diligence requirements. The Corporation has recorded a contingent loss of \$246,104 to cover related losses in the servicing portfolio as of June 30, 2003.